HOUSE BILL 82:
IRC Update

2013-2014 General Assembly

Committee:	Senate Finance	**Date:**	February 27, 2013
Introduced by:	Rep. Howard	**Prepared by:**	Trina Griffin
Analysis of:	Second Edition		Committee Counsel

SUMMARY: House Bill 82 would do the following:

- ***Update from January 1, 2012, to January 2, 2013, the reference to the Internal Revenue Code used in determining certain State tax provisions, thereby incorporating and conforming to many of the provisions contained in the American Taxpayer Relief Act of 2012 (ATRA) to the extent North Carolina law tracks those provisions, including[1]:***
  - ***15-year depreciation schedule for leasehold, restaurant, and retail property***
  - ***Modified limitations on itemized deductions***
  - ***Student loan interest deduction***
  - ***Income exclusion for employer-provided educational assistance programs***
- ***"Decouple" from ATRA enhancements or extensions to the following provisions for the 2013 tax year:***
  - ***Bonus depreciation***
  - ***Section 179 expensing (for 2012 and 2013)***
  - ***Qualified tuition and expenses deduction***
  - ***Mortgage insurance premium as interest deduction***
  - ***Income exclusion for discharge of residence indebtedness***
  - ***Income exclusion for IRA distributions to charity by a person who has attained age 70.5.***
- ***Adjust the following three tax credits that were enhanced by ATRA to achieve revenue neutrality:***
  - ***Work Opportunity credit***
  - ***Earned Income credit***
  - ***Adoption credit***

[As introduced, this bill was identical to S64, as introduced by Sens. Rucho, Rabin, Rabon, which is currently in Senate Finance.]

CURRENT LAW: North Carolina's tax law tracks many provisions of the federal Internal Revenue Code by reference to the Code.[2] The General Assembly determines each year whether to update its reference to the Code.[3] Updating the reference makes recent amendments to the Code applicable to the

[1]The legislation made many other changes that are not discussed in this Analysis because they either had no or minimal impact on North Carolina taxable income.

[2]North Carolina first began referencing the Internal Revenue Code in 1967, the year it changed its taxation of corporate income to a percentage of federal taxable income.

[3]The North Carolina Constitution imposes an obstacle to a statute that automatically adopts any changes in federal tax law. Article V, Section 2(1) of the Constitution provides in pertinent part that the "power of taxation … shall never be surrendered, suspended, or contracted away." Relying on this provision, the North Carolina court decisions on delegation of

State to the extent that State law previously tracked federal law. The General Assembly's decision whether to conform to federal changes is based on the fiscal, practical, and policy implications of the federal changes and is normally enacted in the following year, rather than in the same year the federal changes are made. Maintaining conformity with federal tax law simplifies tax reporting because a taxpayer will not need to account for differing federal and State treatment of the same asset. The current reference to the Code is January 1, 2012.

BACKGROUND: On January 2, 2013, the American Taxpayer Relief Act of 2012 (ATRA) was signed into law[4] and made substantial changes to the tax code. ATRA was intended to avert the anticipated "fiscal cliff" due to the sunset provisions scheduled to take effect in 2013 that would have ended the Bush-era tax cuts contained in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), which were temporarily extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Relief Act).

BILL ANALYSIS:

Update IRC Reference Date

Section 1 of the bill would update the reference to the Code from January 1, 2012 to January 2, 2013, the date that ATRA became law. In doing so, North Carolina would conform to the following provisions:

- 2-year extension of the 15-year depreciation schedule for leasehold, restaurant, and retail property.[5]
- Permanent repeal of the limitation on itemized deductions for filers with incomes below $300,000 (MFJ) and application of the limitation for filers with incomes over $300,000.[6]
- Permanent increased phaseout ranges and elimination of the 60-month rule for the student loan interest deduction.[7]
- Permanent income exclusion for employer-provided educational assistance programs.[8]

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legislative power to administrative agencies, and an analysis of the few federal cases on this issue, the Attorney General's Office concluded in a memorandum issued in 1977 to the Director of the Tax Research Division of the Department of Revenue that a "statute which adopts by reference future amendments to the Internal Revenue Code would … be invalidated as an unconstitutional delegation of legislative power."

[4] P.L. 112-240.

[5] If the provision had not been extended, this property would have been subject to a 39-year recovery period.

[6] Generally, taxpayers itemize deductions if their total deductions are more than the standard deduction amount. Since 1991, the amount of itemized deductions a taxpayer may claim has been reduced by 3% of the amount by which the taxpayer's AGI is above a certain amount. This limitation is known as the Pease limitation. EGTRRA repealed the Pease limitation on itemized deductions for 2010. The 2010 Tax Relief Act extended the repeal through 2012. ATRA permanently repeals the Pease limitation on incomes at or below $250,000 for individual filers and $300,000 for MFJ for tax years beginning after December 31, 2012. ATRA reinstates the limitations for individual filers over $250,000 and for MFJ with AGI over $300,000 beginning in 2013. The deduction phaseout will equal 3% of the taxpayer's AGI over that threshold, although the total phaseout is capped at 80% of the total deductions claimed. If ATRA had not been enacted, the applicable threshold for 2013, as adjusted for inflation, would have been $178,150 for MFJ filers.

[7] Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for interest expenses up to $2,500. Prior to 2001, this benefit was only allowed for 60 months and phased-out for taxpayers with income between $40,000 and $55,000 ($60,000 and $75,000 for joint filers). EGTRRA eliminated the 60-month rule and increased the income phase-out range from $40,000-$55,000 to $50,000-$65,000 ($100,000 and $130,000 for joint filers), with adjustments for inflation. ATRA permanently extends these changes for taxable years beginning after December 31, 2012.

[8] An employee may exclude from gross income up to $5,250 for income and employment tax purposes of employer-provided education assistance. Prior to 2001, this incentive was temporary and only applied to undergraduate courses. EGTRRA

Bonus Depreciation

Section 2 of the bill would not conform to the one-year extension of the 50% bonus depreciation provision for property placed in service before January 1, 2014. The bill would "decouple" in the same manner that has been done in the past. A taxpayer would be required to add back 85% of the accelerated depreciation amount in the year it is claimed for federal purposes with a corresponding 20% deduction over the next five years. The taxpayer would be deducting the same amount of an asset's basis under State law as under federal law, it is just that the timing of the deduction differs. If North Carolina were to conform to this provision, the cost would be approximately $140 million in FY 12-13 and $141 in FY 13-14.

> ***Explained.*** – Businesses may depreciate the cost of a new asset[9] over a period of time, usually five to 15 years. Bonus depreciation allows a business to claim more of a deduction up front and spread the remainder out over the normal depreciation schedule.
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> ***Federal Background.*** – Since 2002, businesses have been authorized to take an additional depreciation deduction on depreciable property ranging from 30% to 100%, known as "bonus depreciation." Most recently, the 2010 Tax Relief Act authorized 100% bonus depreciation for investments placed in service after September 8, 2010, and before January 1, 2012. It also provided 50% bonus depreciation for qualified property placed in service after December 31, 2012, and before January 1, 2013. ATRA extends the 50% bonus depreciation provision for one year.
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> ***North Carolina Background.*** – Since 2002 and through 2012, North Carolina has decoupled from the federal bonus depreciation provisions in the same manner as under this bill.

Section 179 Expensing

Section 3 of the bill would not conform to the enhanced **s**ection 179 expensing provision for 2012 and 2013. Therefore, for North Carolina purposes, a taxpayer would be subject to the deduction and investment limits that would have been in place at the federal level if ATRA had not been enacted: $125,000 and $500,000 for 2012; $25,000 and $200,000 for 2013.

The bill further provides that the property's basis will be the same for federal and State purposes and treats the difference in the same manner as State tax law has historically treated the bonus depreciation: A taxpayer would add back 85% of the additional expensing taken under federal law in 2012 and 2013 and would deduct 20% of this amount over the succeeding five years. Full conformity to the section 179 expense deduction would be $38 million in FY 12-13 and $22 million in FY 13-14.

> ***Explained.*** – Section 179 of the Code allows the expensing of the purchase price of some business assets[10] in the year of purchase rather than taking depreciation[11] throughout the life of the asset. In other words, expensing trades a smaller yearly deduction over time for a larger deduction in year one. Use of the allowance has two components: a deduction limit and a phaseout threshold. The deduction limit is the maximum amount of the deduction that the taxpayer may elect to take. The phaseout threshold is the maximum amount that can be spent on equipment before the deduction begins to be reduced. The deduction is reduced, dollar for dollar, by the amount that exceeds the threshold. Prior to 2010, section 179 was commonly thought to apply to small businesses because of

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expanded this provision to graduate education. ATRA makes these changes permanent for taxable years beginning after December 31, 2012.

[9] One important difference between bonus depreciation and section 179 expensing is that bonus depreciation applies only to new equipment, while section 179 expensing may apply to new and used equipment.

[10] The business asset must be newly purchased tangible personal property that is used more than 50% for business purposes and is eligible to be depreciated under the Code. The newly purchased property may be new or used equipment.

[11] Generally, taxpayers take the Section 179 expensing deduction first and claim bonus depreciation on any remaining basis.

its maximum deduction and investment limits.[12] However, the enhancements made by the Small Business Jobs Act of 2010 (2010 Jobs Act) were the most expansive ever enacted and those limits have been extended under ATRA.

Federal Background. – The 2010 Jobs Act increased the deduction limit for tax years 2010 and 2011 from $250,000 to $500,000 and increased the phaseout from $800,000 to $2 million. The 2010 Jobs Act also broadened the definition of qualified property to include qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property, and computer software. These enhancements were set to expire for the 2012 taxable year with the limits reverting to prior levels of $25,000 and $200,000.

The 2010 Tax Relief Act did not extend the types of property that qualify for the deduction beyond the 2011 taxable year, but it increased the limits for taxable year 2012 to $125,000, adjusted for inflation ($139,000) and $500,000. Under the 2010 Tax Relief Act, the deduction limits were set to revert to their prior levels of $25,000 and $200,000 in 2013.

ATRA increases the section 179 limitations for tax years 2012 and 2013 to the same limitations that applied to 2010 and 2011 and extends the qualified real property allowance through 2013. Qualified property generally consists of qualified leasehold property, restaurant property, and retail improvement property. Taxpayers can deduct up to $500,000 of section 179 property for tax years beginning in 2012 and 2013 with a $2 million phaseout. If ATRA had not been enacted, the federal limits under section 179 would have been $125,000 and $500,000 for 2012 and $25,000 and $200,000 for 2013.

The special rule allowing off-the-shelf computer software to be subject to section 179 expensing was scheduled to expire for software placed in service after 2012. ATRA extended the expensing of such software for another year. Thus, off-the-shelf software placed in service in 2013 is subject to the section 179 expensing election.

North Carolina Background. – Prior to 2010, North Carolina typically conformed to the enhanced section 179 expense deduction provisions. However, given the expansive nature of the enhancements made by the 2010 Jobs Act, North Carolina decoupled by maintaining the limits of $250,000 and $800,000 for taxable years 2010 and 2011. North Carolina conformed to the expanded definition of qualified property in 2011. North Carolina conformed to the $125,000/$500,000 limits for 2012 as originally scheduled under the 2010 Tax Relief Act.

Work Opportunity Tax Credit

Section 4 of the bill would conform to the extension of the work opportunity tax credit under ATRA, but it would adjust the North Carolina credit amount from 6% to 3% for the 2013 tax year to achieve revenue neutrality.

Explained. – The federal work opportunity tax credit is available to employers that hire individuals from the targeted groups listed below. The amount of the credit is generally 40% of the qualified worker's first-year wages up to $6,000.[13] The targeted groups are:

- Qualified individuals in families receiving certain government benefits, including Title IV-A social security benefits (aid for dependent children) or food stamps

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[12] Prior to the Emergency Economic Stabilization Act of 2008 (EESA), deduction limit was $125,000 with a phase-out beginning at $500,000.

[13] $3,000 for summer youths and $12,000, $14,000, or $24,000 for qualified veterans, providing certain requirements are met. For long-term family aid recipients, the credit is equal to 40% of the first $10,000 in qualified first year wages and 50% of the first $10,000 of qualified second-year wages.

- •Qualified individuals who receive supplemental social security income or long-term family assistance
- •Veterans who are members of families receiving food stamps, who have service-connected disabilities, or who are unemployed
- •Designated community residents
- •Vocational rehabilitation referrals certified to have physical or mental disabilities
- •Qualified summer youth employees who live in empowerment zones, enterprise communities, or renewal communities
- •Ex-felons hired no more than one year after the later of their conviction or release from prison

Federal Background. – The credit was scheduled to terminate in 2012 for wages paid to all targeted individuals, except for qualified veterans. The credit as it applies to wages paid for qualified veterans was scheduled to terminate in 2013. ATRA extended the credit for all groups for two-years through 2013.

North Carolina Background. – North Carolina provides a State income tax credit to a taxpayer who is allowed a work opportunity tax credit under the Internal Revenue Code. The amount of the credit is equal to 6% of the amount of credit allowed under the Code.[14] The credit is set to expire January 1, 2014.

Deduction for Qualified Tuition and Related Expenses

Section 5 of the bill would not conform to the federal enhancements of the qualified tuition and expenses deduction. A taxpayer would be required to add back the amount of the deduction taken at the federal level for purposes of determining North Carolina taxable income. If North Carolina were to conform to this provision, the cost would be approximately $6 million in FY 13-14.

Explained. – Subject to income limitations, a taxpayer may take an above-the-line deduction for qualified education expenses paid during the year for the taxpayer or the taxpayer's spouse or dependents. Generally, any accredited public, nonprofit, or proprietary post-secondary institution is an eligible educational institution. The maximum deduction is $4,000 for an individual whose adjusted gross income for the tax year does not exceed $65,000 ($130,000 for MFJ filers), or $2,000 for other individuals whose adjusted gross income does not exceed $80,000 ($160,000 for MFJ filers).

Federal Background. – This deduction was established under EGTRRA and scheduled to expire in 2006. It was subsequently extended through 2011. ATRA extends the deduction for two more years through 2013.

North Carolina Background. – North Carolina has previously conformed to this provision.

Section 5(b) disallows, for tax year 2013, the State deduction for taxpayers who opted to claim the Hope scholarship credit, the Lifetime Learning credit, or the American Opportunity tax credit in lieu of the federal deduction for tuition and fees.

At the federal level, a taxpayer may opt to claim one of the three above-named credits in lieu of the deduction for tuition and fees. A taxpayer who does so is eligible to claim a deduction on the North Carolina tax return for the tuition and fees deduction they forfeited on the federal return that they would have otherwise been entitled to claim had they not chosen to take one of the federal credits. By disallowing the State deduction, taxpayers are treated similarly regardless of whether they elected the

[14] The credit may be claimed against the franchise tax or the income tax. The taxpayer must elect the tax against which a credit will be claimed when filing the return; the election is binding. The credit allowed may not exceed 50% of the tax against which it is claimed. Any unused portion of the credit may be carried forward for five years.

federal credit or the federal deduction. Otherwise, a taxpayer who claims the federal deduction would get no State tax benefit (to the extent this bill requires an addback for that deduction) while those who claim the federal credit would be entitled to the State tax deduction.

Income Exclusion for Distributions from IRAs to Charity

Section 6 of the bill would not conform to the extension of the income exclusion for a qualified charitable distribution from an individual retirement plan by a person who has attained the age of 70½. It would require a taxpayer to add back the amount excluded at the federal level for purposes of determining North Carolina taxable income. If North Carolina were to conform to this provision, the cost would be approximately $3 million in FY 13-14.

> ***Explained.*** – Generally, a taxpayer must include in gross income distributions made from a traditional or Roth IRA account except to the extent they represent a return of nondeductible contributions or are rolled over into another qualified retirement plan.
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> ***Federal Background.*** – Since 2006,[15] taxpayers age 70½ or older may contribute up to $100,000 from their IRA account to a charity tax-free. This income exclusion was set to expire for distributions made in tax years beginning after December 31, 2011. ATRA extends the availability of this exclusion for two years for distributions made in tax years beginning in 2012 and 2013.
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> ***North Carolina Background***. – North Carolina has previously conformed to this provision.

Section 6(b) would allow a taxpayer age 70½ or older to take a charitable deduction for the donation of an IRA distribution to charity to the extent the taxpayer was required to add back the amount excluded from gross income at the federal level.

At the federal level, a taxpayer may not get a double benefit for donating an IRA distribution to charity by both excluding it from income and taking the charitable deduction. A taxpayer may elect one but not both. If a taxpayer elects to take the 170 charitable deduction at the federal level, the deduction would flow through for North Carolina purposes.[16] However, if a taxpayer elects the income exclusion, there would be no benefit at the State level because, under this act, a taxpayer would be required to add that amount back. Therefore, this section would allow the taxpayer to take a charitable deduction for that contribution.

Income Exclusion for Discharge of Qualified Principal Residence Indebtedness

Section 7 of the bill would not conform to the extension of the income exclusion for the discharge of qualified principal residence indebtedness. It would require a taxpayer to add back the amount excluded at the federal level for purposes of determining North Carolina taxable income. If North Carolina were to conform to this provision, the cost would be approximately $8 million in FY 13-14.

> ***Explained.*** – Taxpayers are generally required to recognize income from the discharge of indebtedness. An exception from this rule is for the discharge of qualified principal residence indebtedness, which has been excludible from gross income on a temporary basis since 2007.[17] The exclusion is limited to $2 million, and applies to indebtedness incurred in the acquisition, construction, or substantial improvement of a principal residence and secured by the residence.
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> ***Federal Background.*** – This exclusion was scheduled to expire for debt discharged after December 31, 2012, but was extended for one year under ATRA.

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[15] This exclusion was originally authorized by the Pension Protection Act of 2006. The law was extended through 2009 by the Emergency Economic Stabilization Act of 2008, and through 2011, by the 2010 Tax Relief Act.
[16] Nonitemizers may take the credit under G.S. 105-151.26.
[17] This exclusion was originally authorized in the Mortgage Debt Relief Act of 2007.

North Carolina Background. – North Carolina has previously conformed to this provision.

Deduction for Mortgage Insurance Premiums as Interest

Section 8 of the bill would not conform to the extension of the deduction for mortgage insurance premiums as interest. It would require taxpayers to add back the amount they took as a deduction at the federal level for purposes of determining North Carolina taxable income. If North Carolina were to conform to this provision, the cost would be approximately $6 million in FY 13-14.

Explained. – Generally, taxpayers may not deduct any interest paid or accrued during the tax year that is considered personal interest. This restriction does not apply to certain types of interest, including qualified residence interest. Qualified residence interest includes interest on home acquisition indebtedness of up to $1 million and interest on home equity indebtedness of up to $100,000. In the case of a home acquisition loan, an individual who cannot pay the entire down payment amount may be required to purchase mortgage insurance.

Federal Background. –Since 2006, premiums paid for qualified mortgage insurance in connection with acquisition indebtedness for a qualified residence are treated as qualified residence interest and are deductible.[18] The treatment of qualified mortgage insurance as qualified residence interest was set to expire for amounts paid or accrued after December 31, 2011. ATRA extends the availability of the deduction for two years through 2013.

North Carolina Background. – North Carolina has previously conformed to this provision.

Earned Income Tax Credit

Section 9 of the bill would conform to changes made under ATRA to the earned income tax credit, but it would adjust the North Carolina credit amount from 5% to 4.5% for the 2013 tax year to achieve revenue neutrality.

Explained. – The EITC is a refundable tax credit for working low to moderate income families that varies depending on the number of the taxpayer's qualifying children.

***Federal Background*.** –EGTRRA made a number of changes to simplify the credit and to reduce the marriage penalty experienced by married taxpayers claiming the credit. The American Recovery and Reinvestment Act of 2009 (ARRA) increased the credit amount from 40% to 45% of a family's first $12,570 of earned income for families with three or more children and the beginning point of the phase-out range for married coupled filing a joint return by $1,880. The enhancements were set to expire for the 2011 taxable year. The 2010 Tax Relief Act extended the enhancements through the 2011 and 2012 taxable years. ATRA extends for five additional years, through 2017, the expansions that increased the EITC for families with three or more children and increased the phase-out range for all married couples filing a joint return.

North Carolina Background. – North Carolina provides a State income tax credit to a taxpayer who is eligible for the federal EITC. The amount of the credit is equal to 5% of the amount of credit allowed under the Code. The credit is set to expire January 1, 2014. North Carolina conformed to the EGTRRA enhancements to the federal credit in 2001 and to the extension of those enhancements under the 2010 Tax Relief Act.

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[18] The deduction is subject to a phaseout. For every $1,000, or fraction thereof, by which the taxpayer's AGI exceeds $100,000, the amount of mortgage insurance premiums treated as interest is reduced by 10%.

Adoption Credit

Section 10 of the bill would conform to changes made under ATRA to the adoption credit, but it would adjust the North Carolina credit amount from 50% to 30% for the 2013 tax year to achieve revenue neutrality.

Explained. – Taxpayers who adopt children can receive a tax credit for adoption expenses. Qualified adoption expenses include adoption fees, court costs, attorney fees, and other expenses related directly to the legal adoption of an eligible child. A taxpayer may also exclude from income adoption expenses paid by an employer.

Federal Background. –EGTRRA increased the credit from $5,000[19] to $10,000, and provided a $10,000 income exclusion for employer-assistance programs. The Patient Protection and Affordable Care Act of 2010 extended these benefits to 2011 and made the credit refundable. The 2010 Tax Relief Act extended the enhancements made by EGTRRA for one year. ATRA made permanent the increased adoption credit amount and the exclusion for employer-assistance programs as enacted in EGTRRA. Therefore, the adoption credit and income exclusion maximum amounts are $10,000, adjusted for inflation, with an income phase-out range between $150,000 and $190,000, adjusted for inflation

North Carolina Background. – North Carolina provides a State income tax credit to a taxpayer who is eligible for the federal adoption credit. The amount of the credit is equal to 50% of the amount of credit allowed under the Code. The credit is set to expire January 1, 2014. North Carolina conformed to the EGTRRA enhancements to the federal credit in 2001 and to the extension of those enhancements under the 2010 Tax Relief Act.

[19] $6,000 for a special needs child.

IRC Update

Federal Provision	Decouple/Conform		Cost to Conform		2 FY Total
	For tax year 2012	For tax year 2013	FY12-13	FY13-14	
BUSINESS-RELATED PROVISIONS					
Bonus Depreciation	(No 2012 law change)	Decouple			
Enhanced Section 179 Expensing	Decouple	Decouple			
15-year depreciation schedule for leasehold, restaurant, and retail property	Conform	Conform	-2	-3	
Work Opportunity Tax Credit	Conform	Conform & Adjust	-1		
INDIVIDUAL-RELATED PROVISIONS					
Limitation on Itemized Deductions	(No 2012 law change)	Conform	-1	-3	
Education-Related Expenses					
• Qualified Tuition & Expenses Deduction	Conform	Decouple	-3		
• Student Loan Interest Deduction	Conform	Conform	-3	-6	
• Income Exclusion for Employer-Provided Education Assistance	Conform	Conform	-3	-6	
Residence-related Benefits					
• Mortgage Insurance premium as interest	Conform	Decouple	-5		
• Income exclusion for discharge of residence indebtedness	(No 2012 law change)	Decouple	-2		
Tax-free distribution from IRAs to charity/age 70.5 or older	Conform	Decouple	-4		
Earned Income Tax Credit	(No 2012 law change)	Conform & Adjust			
Adoption Tax Credit	(No 2012 law change)	Conform & Adjust			
			-24	-18	-42